Outlook themes

• The US remains in a moderate growth environment
• The unemployment rate is 8.1%, close to its value in January
• The recovery in the housing sector is gaining traction
• Core measures of inflation remain in line with 2% goal, with upside risk to headline measures due to food and energy
• Major risk factors: Europe and the fiscal cliff
Since the end of the recession, growth has been moderate.
The unemployment rate is little changed since January.
Gains in job openings continue to outpace gains in hiring

Source: Bureau of Labor Statistics, Haver Analytics
Long-term unemployment remains elevated

Share of Long-term Unemployed (27+ weeks)

Source: Bureau of Labor Statistics, Haver Analytics
Consumers still remain heavily indebted, but have made substantial progress in deleveraging the past few years.
Household wealth has fluctuated over the past 15 years, but remains above its level from 1985-1995.

Source: Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics
Companies appear cautious about their capital spending, as orders for new capital equipment have been declining.

Source: Census Bureau, Haver Analytics
House prices are showing convincing signs of increasing.
Construction of multi-family housing units continues to trend higher

Source: Census Bureau, Haver Analytics
Inflation is running a bit below 2%

Source: Bureau of Economic Analysis
Retail gasoline prices have moved up sharply over the past month.

Retail gasoline prices have moved up sharply over the past month.
Retail food prices are likely to move higher in coming months

Index: Jan 2, 1970 = 100

Source: Standard & Poor’s, Bureau of Labor Statistics, Haver Analytics
Risk Factor #1: The European trilemma

Sovereign debt crisis – Poor fiscal management and rising bond yields in some countries threaten fiscal sustainability.

Banking crisis – A property bust in some markets and a decline in sovereign debt values have impaired eurozone banks.

Slow growth / recession – Tighter fiscal policy and financial conditions, plus uncertainty, is weighing on growth.
Sovereign yields have diverged

10 Year Sovereign Yields

Greece  Portugal  Spain  Ireland  Italy  France  Germany

Source: Bloomberg
The rise in sovereign yields reflects concerns over fiscal sustainability

Source: Bloomberg, Eurostat
Euro area and US growth looked similar during the recession, though Euro area growth has now stalled.
A challenging negative feedback cycle...

Government balance sheet

- Future tax revenue
- Sovereign debt

Banking sector balance sheet

- Sovereign debt
- Loans
- Equity
- Debt

Weak tax revenue → Real economy → Fiscal tightening

Decline in market value → Deleveraging pressure

Slow loan growth → Higher funding costs

Solvency concerns
Risk Factor #2: US fiscal policy

• According to the Congressional Budget Office the full impact of the “fiscal cliff” will cause a recession in 2013

• If the fiscal cliff is avoided:
  
  – Deficits are likely to improve in the next few years, but will remain large by historical standards

  – Debt will rise at an unsustainable pace and further accelerate later this decade
Without Congressional action, US federal fiscal policy will tighten by about $560bn in 2013.

- $399 bn Expiring tax provisions and new taxes
- $105 bn Other
- $103 bn sequestration, extended UI benefits, “doc fix”

Source: Congressional Budget Office
The Congressional Budget Office is forecasting a recession under current law (i.e. the fiscal cliff is fully realized)

Source: Congressional Budget Office, Haver Analytics
Private forecasters project continued growth and presumably, that the fiscal cliff will be avoided.

Source: Blue Chip Economic Indicators, Congressional Budget Office, Haver Analytics
Hitting the cliff may be undesirable in terms of growth, but would notably decrease deficits in the coming years.

Source: Congressional Budget Office, Haver Analytics
Extending existing policies will cause deficits to widen dramatically

Source: Congressional Budget Office, Haver Analytics
Deficits could begin persistently widening sooner than 2015 if growth disappoints.
Extending existing policies will create a mountain of debt

Source: Congressional Budget Office, Haver Analytics
Despite forecasts of rapidly rising debt levels, yields continue to decline

Source: Financial Times, Haver Analytics
Forecasts of large fiscal deficits have not caused inflation expectations to rise

Source: Federal Reserve Board, Haver Analytics
Final points

• The Congressional Budget Office forecasts that the US will experience a recession if the fiscal cliff is fully realized

• A fiscal tightening, however, will notably improve medium- and longer-term deficit projections

• A “grand bargain” before Dec 31, 2012 that smoothes out the timing of the fiscal tightening is the best option